September 3, 2009

MEMORANDUM

TO: Representative Luciano "Lucky" Varela, LFC Chair
Legislative Finance Committee Members

FROM: Dan White, LFC Senior Economist
Michelle Aubel, LFC Principal Analyst

SUBJECT: LFC Report of Investment Performance – FY2009 Fourth Quarter

Investment Performance Highlights:

- All state investment agencies improved in terms of absolute performance during the fourth quarter of FY09. However, the Educational Retirement Board (ERB) was the only fund to outperform quarterly benchmarks. **For the first time in six quarters all four funds were able to achieve positive returns.**

- The State Investment Council (SIC) managed Land Grant Permanent Fund (LGPF and Severance Tax Permanent Fund (STPF) were the state's worst performing funds in the fourth quarter, underperforming respective benchmarks by 750 and 620 basis points (bps)[1]. The underperformance represents a nearly 180 degree turnaround from the third quarter of FY09 when the funds outperformed their respective benchmarks by 620 and 650 bps, respectively. The magnitude of the underperformance was enough to pull the majority of the funds' long-term performance numbers below relative benchmarks as well.

- The majority of the permanent funds' underperformance is due to a $322 million mark-to-market write down recorded as an unrealized loss at the end of the fiscal year. The loss occurred within the funds' normally conservative securities lending program, and will be discussed in more detail in this quarter's special focus section.

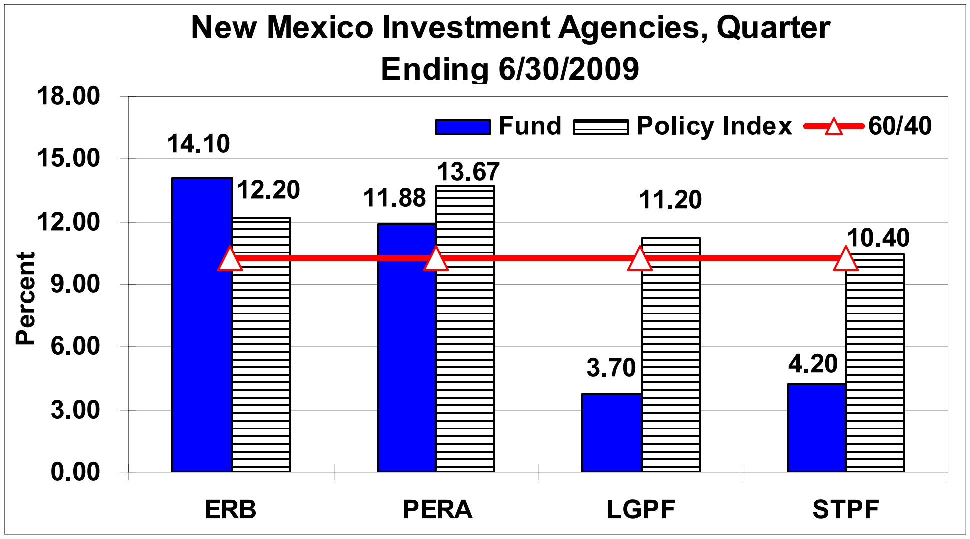
- The performance of the Public Employees Retirement Association (PERA) improved in absolute terms but underperformed respective benchmarks by a wider margin than in the third quarter. The fund's 179 bps underperformance marks the seventh consecutive quarter it has failed to meet respective benchmarks. The fund is now underperforming its 5-year benchmark by 181 bps.

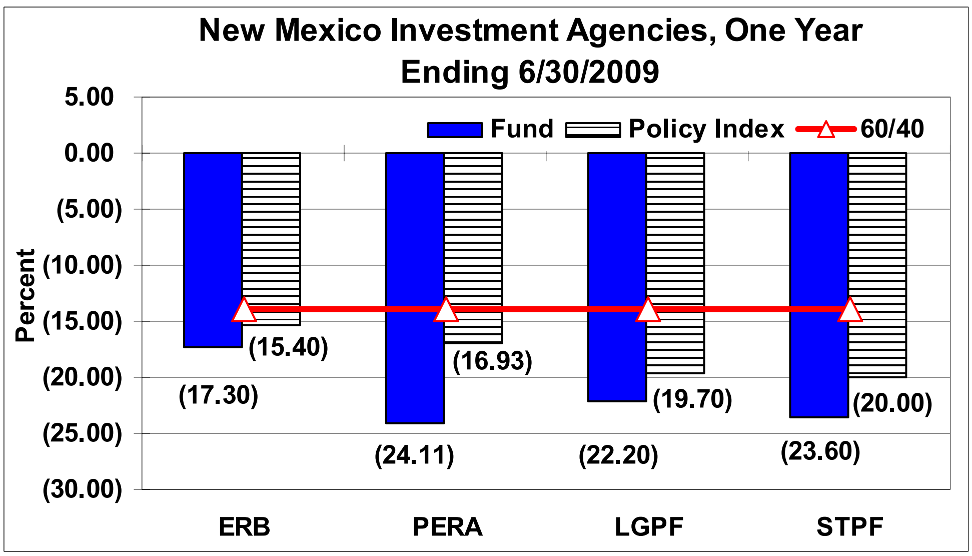
- ERB was the best performing fund in the fourth quarter of FY09. The fund outperformed its benchmark by an impressive 190 bps, marking the first time the fund has outperformed in four quarters. Despite its continued improvement, the fund is still underperforming both one-year and five-year benchmarks.

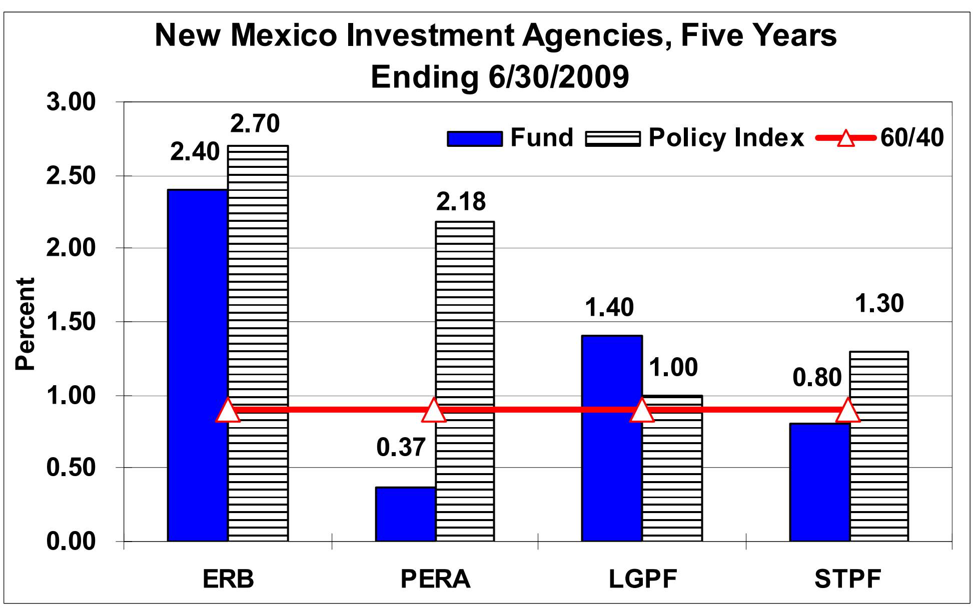
- Peer rankings, while improved for the quarter for PERA and ERB, remain particularly low for SIC and longer-term pension performance.

[1] A basis point represents one hundredth (0.01) of one percent. Thus if the LGPF outperformed its benchmark by 620 bps, it outperformed by 6.20 percent.

OVERALL FUND PERFORMANCES vs. RELATIVE BENCHMARKS







FUND ASSET VALUES

Total asset values for all funds rebounded by just over $2 billion in the fourth quarter of FY09. Most of that rebound came from the pension plans. ERB saw a significant increase of $853 million, or 13.7 percent, and PERA increased its total assets by $870 million, or 10.6 percent. The permanent funds saw more modest gains of 2.7 and 3.5 percent, respectively. The fourth quarter marked the first quarter in more than a year and a half that all four funds were able to simultaneously increase their respective asset values. However, total asset values remain down for the year, losing over $8.7 billion. Reported asset values reflect contributions and distributions as well as investment returns.

Current Asset Values (millions)
For Quarter and Year Ending June 30, 2009

Quarterly	ERB	PERA*	LGPF	STPF	TOTAL
Current Asset Values (6/30/09)	$ 7,061	$ 9,057	$ 7,929	$ 3,179	$ 27,226
Value Change (Previous Quarter)	853	870	204	105	2,033
Percent Change	13.7%	10.6%	2.7%	3.5%	6.4%

Annual	ERB	PERA*	LGPF	STPF	TOTAL
Ending Asset Values (6/30/09)	$ 7,061	$ 9,057	$ 7,929	$ 3,179	$ 27,231
Value Change (Year Ago)	(1,680.4)	(3,133.5)	(2,342.0)	(1,525.1)	(8,680.9)
Percent Change	-19.2%	-25.7%	-22.8%	-32.4%	-24.2%

ACTUAL VS. TARGET ASSET ALLOCATIONS

All funds' alternative allocations were higher than target allocations due primarily to the "denominator effect" caused by a rapid decrease in overall fund values and lagged alternative valuations. This is particularly true with private equity investments. Given time these allocations should come back into line with target levels. ERB was slightly over allocated to fixed income during the quarter which proved beneficial to overall returns. The STPF on the other hand was significantly under allocated to fixed income during the quarter which hampered overall returns.

Fund Asset Allocation Detail, Quarter Ending June 30, 2009

	ERB*		PERA		LGPF		STPF	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	**29.8%**	**40.0%**	**37.7%**	**38.0%**	**45.4%**	**51.0%**	**46.2%**	**48.0%**
International Equity	**17.3%**	**20.0%**	**17.6%**	**25.0%**	**8.1%**	**10.0%**	**9.8%**	**10.0%**
Fixed Income	**36.6%**	**29.0%**	**30.6%**	**29.0%**	**18.0%**	**15.0%**	**2.5%**	**11.0%**
Total Alternatives	**15.1%**	**11.0%**	**8.2%**	**8.0%**	**26.5%**	**24.0%**	**39.7%**	**31.0%**
Private Equity	2.3%	1.0%	1.6%	2.0%	9.5%	6.0%	16.5%	12.0%
Real Estate/Real Assets	5.2%	5.0%	1.0%	1.0%	3.9%	3.0%	4.9%	3.0%
Absolute Return	7.6%	5.0%	5.6%	5.0%	13.1%	15.0%	13.2%	15.0%
ETI	N/A	0.0%	N/A	0.0%	0.0%	0.0%	5.1%	1.0%
Cash Equivalents	**1.2%**	**0.0%**	**5.9%**	**0.0%**	**2.2%**	**0.0%**	**1.7%**	**0.0%**
Total Fund %	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**

**ERB is is adopting a new asset allocation mix that will raise its commitment to alternatives to 35% and correspondingly reduce equity and fixed income asset classes.*

***Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.*

FUND PERFORMANCE AND PEER RANKINGS

Peer Percentile Rankings*

	QTR	1 Year	5 Year	10 Year
ERB	15	57	46	92
PERA	34	93	98	76
LGPF	87	89	73	80
STPF	86	93	87	83

* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds. Permanent Funds relative to U.S. Endowment Funds.

Both pension funds dramatically improved their relative peer rankings in the fourth quarter of FY09 while both permanent funds simultaneously worsened their rankings. ERB's quarterly returns were particularly helpful to its one-year and five-year rankings. Despite encouraging quarterly rankings from ERB and PERA, both funds leave room for significant improvement in their long-term rankings. The quarterly performances of both permanent funds had devastating effects on long-term performance, dragging down the funds' five-year returns from the 34th and 46th percentiles to the 73rd and 87th percentiles respectively.

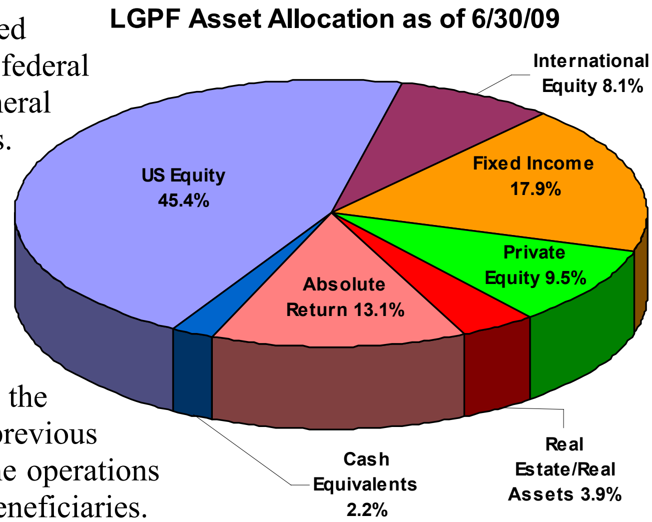
ECONOMIC AND FINANCIAL MARKET ENVIRONMENT

The fourth quarter of FY09 saw financial markets enter the initial stages of what could be a substantial recovery. Equity markets, in particular, began to see significant gains as investors began to shy away from risk-averse treasury investments. The Standard and Poor's 500 Index (S&P 500), for example, posted its best quarterly returns since 2003, finishing the quarter up 15 percent. Emerging markets showed the most strength during the quarter, however, with markets in India and Shanghai finishing the quarter up 49 percent and 25 percent, respectively. Most analysts continue to see these markets as oversold and expect the recent rally to continue throughout most of the first half of FY10. While the embrace of additional risk by investors proved beneficial to equity markets, the Treasury market suffered. The Merrill Lynch Treasury Index suffered losses of 4.5 percent during the second half of FY09, the index's worst six-month performance since its inception in 1977. By contrast, the return on investment-grade corporate bonds increased nearly 11 percent for the quarter while high-yield issuances soared to returns in excess of 20 percent. The yield curve however continued to steepen, showing a heightened concern by investors of long-term inflation most likely due to the increasing federal deficit and the possibility of a sustained, low-interest-rate environment.

Although economic data for the quarter was mixed, many economists, including Fed Chairman Bernanke, have stated that they see economic activity "leveling out." The Federal Open Market Committee (FOMC) has stated that they will most likely keep the target fed funds rate at unprecedented lows for "an extended period." The FOMC has also stated that it plans to reduce some of its quantitative easing programs. The most visible of such initiatives, the direct purchase of large amounts of Treasury securities, is expected to be phased out by the end of October. The Fed is expected to continue it policy of low interest rates until a sustainable decline in the unemployment rate becomes evident, which most forecasting services don't anticipate until the start of FY11.

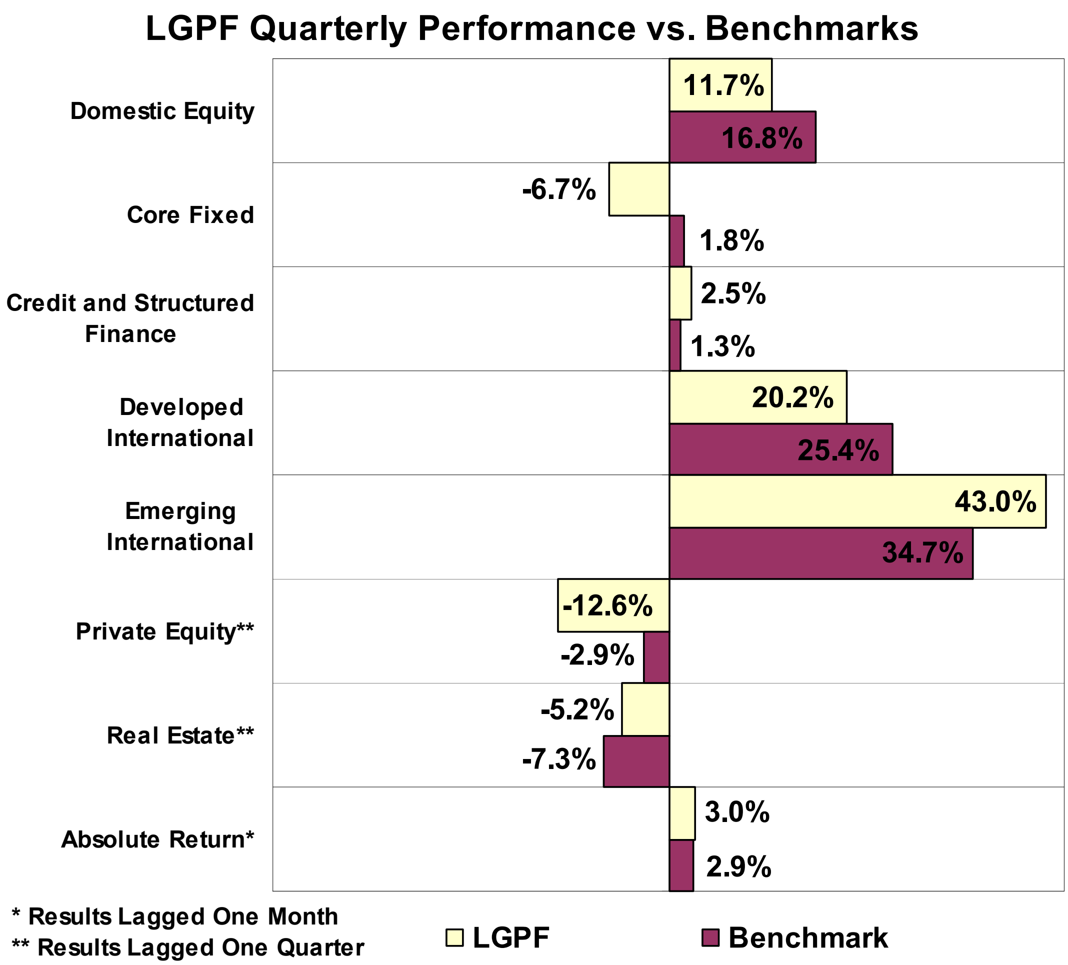
Land Grant Permanent Fund (LGPF)

Fund Objective: The LGPF is derived from proceeds of sales of state and federal public lands and royalties from mineral and timber production on state lands. The fund is invested by the state investment officer according to the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund makes annual distributions to the general fund of 5.8 percent of the average ending balance from the previous five calendar years, which support the operations of public schools and various other beneficiaries.



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
3.70%	11.20%	87	-22.20%	-19.70%	89	1.40%	1.00%	73

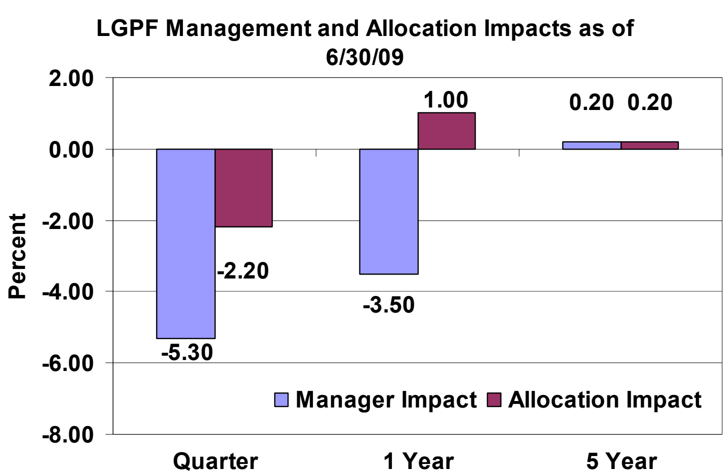


* Results Lagged One Month
** Results Lagged One Quarter

Contributing Factors: The LGPF drastically underperformed its quarterly policy benchmark by 750 bps during the fourth quarter of FY09. The underperformance was so large that it pulled the fund's five-year peer ranking against other U.S. endowment funds from the 34th percentile to the 73rd percentile in only one quarter. The majority of the fund's underperformance stems from large write-downs within its securities lending program. The program, discussed in more detail in this quarter's special focus section, allows the permanent funds to "lend" securities to other investors who then provide collateral in excess of 100 percent of the value of the loaned securities. The collateral is then re-invested in low risk highly liquid securities such as commercial paper, U.S. agency securities, and CD's. The LGPF suffered substantial losses because it re-invested collateral in corporate paper, such as Lehman Brother's, that has been significantly devalued over the past year. If not for losses suffered as a result of these write-downs, the fund's quarterly return would have been nearly 300 bps higher.

Unfortunately the securities lending write-downs were not the only factor in the fund's underperformance. Excluding losses related to securities lending, the fund significantly underperformed in domestic and developed international equities, core fixed income, real estate, and private equity. This is the first quarter in some time where active management has had such a widespread negative impact upon the fund's overall performance. The underperformance in the fund's core bonds pool is particularly troubling, as noted in last quarter's report; "consistent fixed income underperformance is disturbing given the asset class's traditionally safe and conservative nature." The fund's fixed income returns have underperformed throughout the majority of FY09 excluding the effects of the securities lending write-downs. Despite stellar returns throughout the majority of the fiscal year, the fund's domestic equity returns substantially underperformed during the fourth quarter as well.

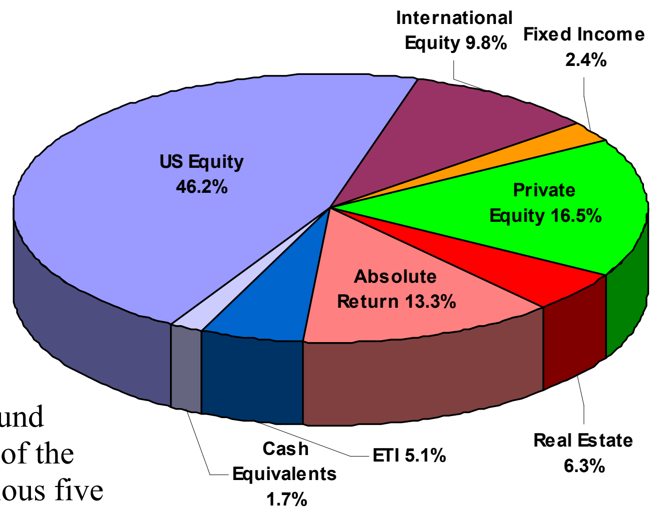
Management and Allocation Impacts: In the fourth quarter of FY09, active management cost the fund's overall return 530 bps while asset allocation cost the fund 220 bps. This marks a sharp drop off from the previous quarters in which active management had an extremely positive effect upon overall returns and allocation effects were marginally positive. The magnitude of this quarter's negative performance also caused the one-year management impact to turn definitively negative. The large write-downs in the fund's securities lending program contributed to a large portion of these negative management impacts. However, active management outside of the program also significantly underperformed particularly in the areas of domestic equity and core bonds.



Severance Tax Permanent Fund (STPF)

Fund Objective: The STPF receives contributions from the portion of severance tax proceeds not required for retirement of severance tax bonds. The fund is invested by the state investment officer under the Prudent Investor Act seeking to preserve capital for future generations of New Mexicans. The fund currently makes annual general fund distributions consisting of 4.7 percent of the average ending balance from the previous five calendar years.

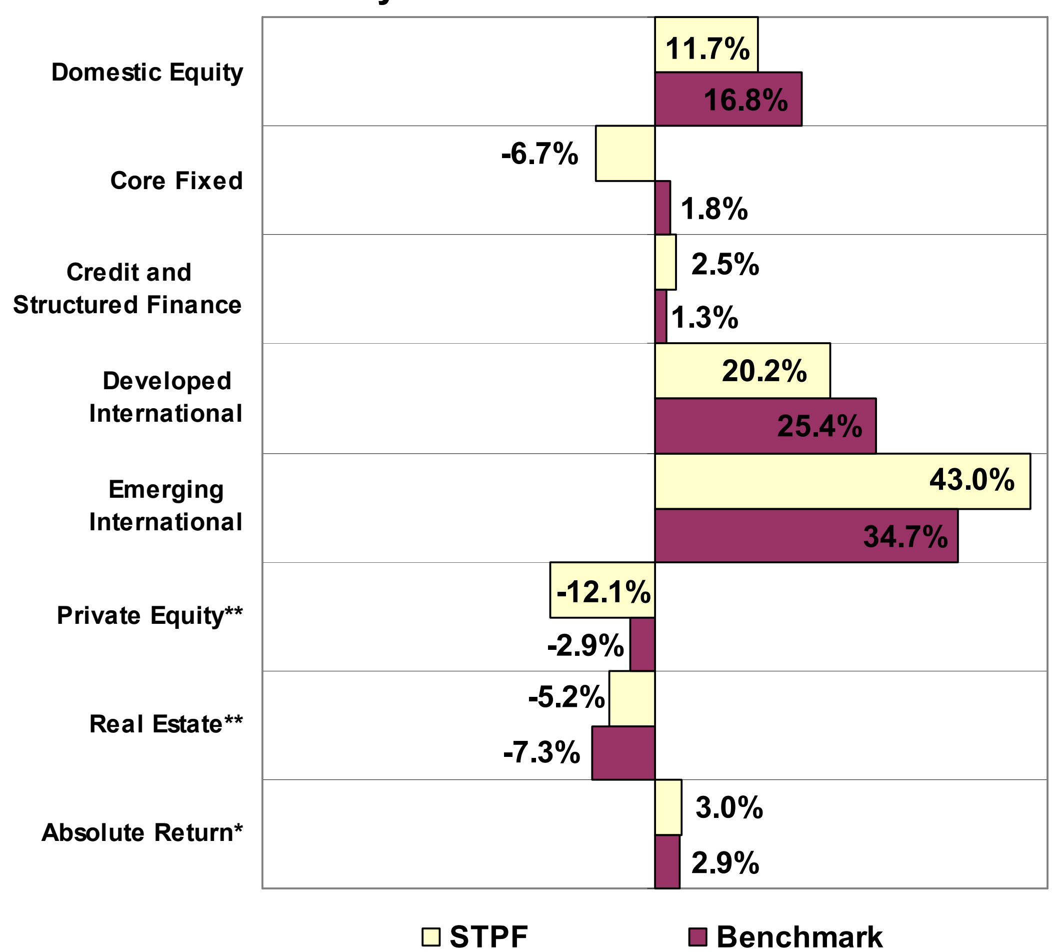
STPF Asset Allocation as of 6/30/09



Fund Performance vs. Policy Benchmarks

Quarter			1 Year			5 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
4.20%	10.40%	86	-23.60%	-20.00%	93	0.80%	1.30%	87

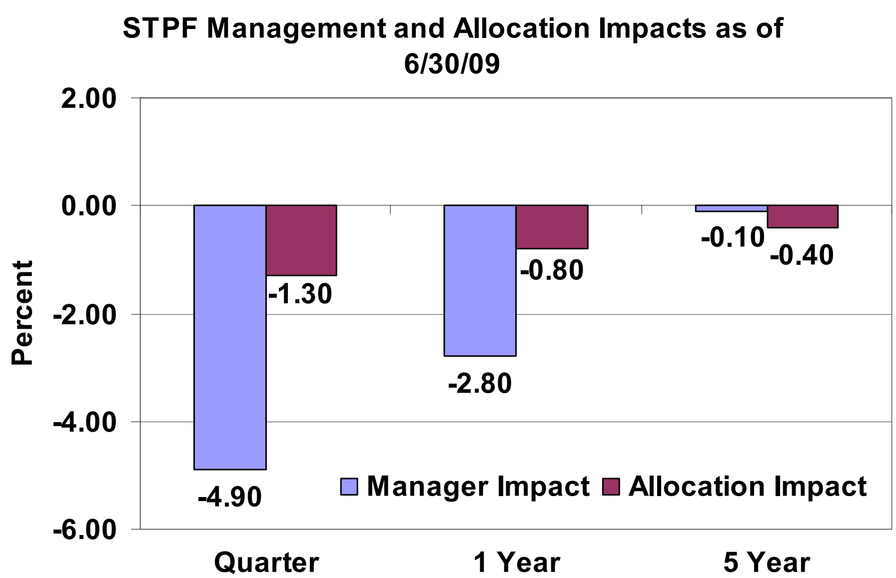
STPF Quarterly Performance vs. Benchmarks



Contributing Factors: The STPF severely underperformed its quarterly policy benchmark by 620 bps during the fourth quarter of FY09. The underperformance was so large that it pulled the fund's five-year peer ranking against other U.S. endowment funds from the 46th percentile to the 87th percentile in only one quarter. The majority of the fund's underperformance stems from large write-downs within the SIC securities lending program. The program, discussed in more detail in this quarter's special focus section, allows the permanent funds to "lend" securities to other investment entities collateralized in excess of 100 percent of the value of the loaned securities. The collateral is then re-invested in low risk highly liquid securities such as commercial paper, U.S. agency securities, and CD's. The STPF suffered such substantial losses due to the fact that it re-invested collateral in corporate paper, such as Lehman Brother's, that has been significantly devalued over the past year. If not for losses suffered as a result of these write-downs the fund's quarterly return would have been nearly 300 bps higher.

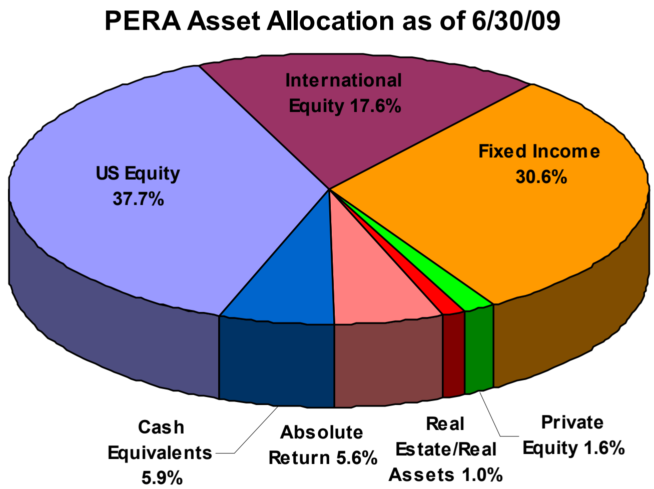
The STPF outperformed the LGPF for the first quarter in some time. The main reason for this difference in performance between the two funds is the STPF's relatively high alternative asset allocation combined with its relatively low fixed income allocation. The alternative portion of the STPF portfolio, which has caused the fund to underperform the LGPF for the majority of FY09, meant the fund had relatively lower exposure to securities lending write downs than the LGPF. Excluding its losses related to securities lending, the STPF still substantially underperformed in a number of asset classes, most importantly domestic and private equity. Although both permanent funds' private equity programs drastically underperformed benchmarks, the STPF had a much higher allocation to private equity and thus suffered more from the underperformance.

Management and Allocation Impacts: In the fourth quarter of FY09, active management cost the fund 490 bps while asset allocation cost the fund 130 bps. The allocation impact was 40 bps better than the LGPF due primarily to the funds large alternative asset allocation. This proved beneficial to the fund as a large portion of that allocation is intended to be an alternative for fixed income assets. Thus the fund had a much lower exposure to the asset class which suffered the greatest losses as a result of securities lending write downs.



Public Employees Retirement Association (PERA)

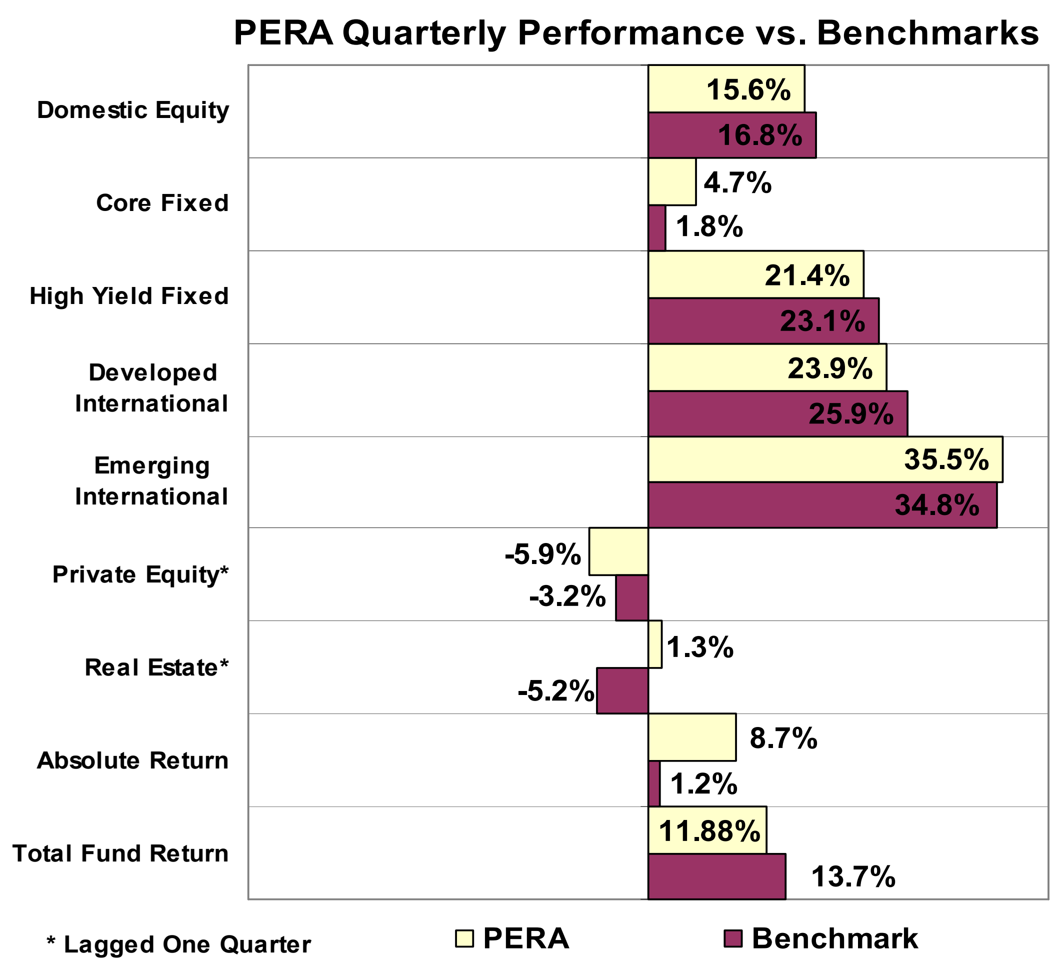
Fund Objective: PERA administers 31 pension plans covering state and local government employees, volunteer firefighters, judges, magistrates and legislators to provide secure retirement. The fund is invested according to the "prudent investor rule" and results are reported in the aggregate.



Fund Performance vs. Relative Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-24.11%	-16.93%	93	0.37%	2.18%	98	2.72%	2.45%	76

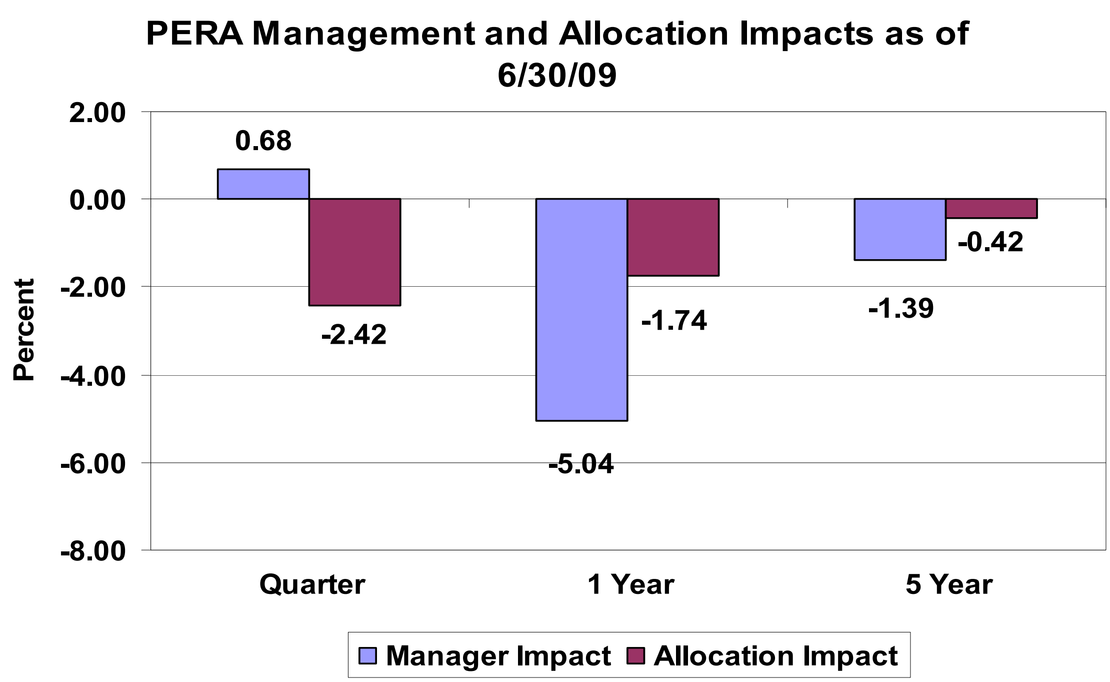
*PERA also has a long-term 8% actuarial benchmark for funding purposes.



Overview: PERA missed its overall interim policy benchmark for the seventh consecutive quarter, this time by 179 bps. Although the fund's quarterly peer ranking improved from the 86th percentile for the third quarter to the 33rd percentile in the fourth quarter, its one-year and five-year rankings remain in the bottom seven percent of all U.S. public funds. Also improved, the fund's 10-year return 2.72 percent still remains a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits. The fund's poor performance during 2008 and 2009 continues to raise questions whether future contribution increases or other measures to reduce liabilities will be necessary to ensure long-term solvency.

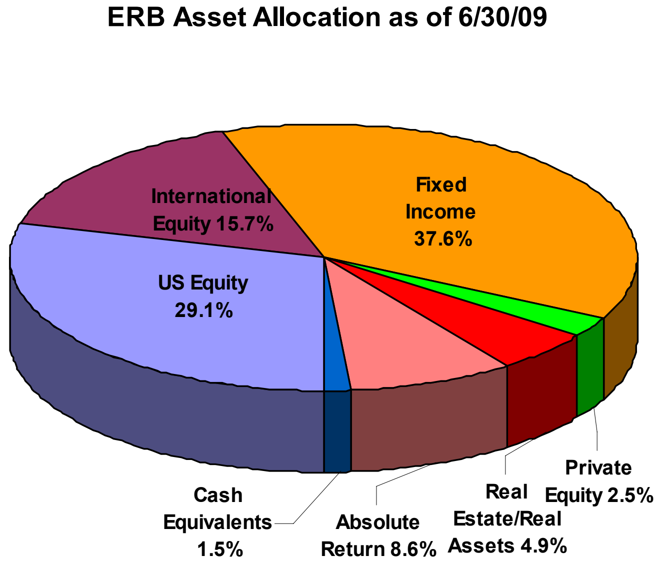
PERA attributes the overall fund's underperformance of 179 bps primarily to asset allocation, underweighting international equity and overweighting the cash allocation during a quarter when international equity posted spectacular gains. In most cases, the manager underperformance that had been dragging returns downward for the first three quarters improved. For the first time in several quarters, the core fixed income portfolio outperformed its benchmark, most likely reflecting the resumption of more normal credit markets that reward risk rather than demand security in Treasuries. The absolute return composite (hedge funds) continued its positive performance from the third quarter, posting a return 750 bps over its benchmark of LIBOR plus 4 percent. The final asset class outperforming its benchmark, emerging international assets, contributed 63 bps of outperformance. While underperforming on a relative basis, domestic equity and developed international asset classes both contributed significant gains. The portable alpha program, reinstituted during the quarter, also added a 10 percent positive return. These absolute returns helped reduce the fiscal year's negative return from -32 percent as of December 2008 to -24 percent at yearend.

Management and Allocation Impacts: Reversing prior attribution patterns, active management added 68 bps in the third quarter of FY09. Active management has consistently hurt PERA returns as shown in the longer-term numbers, particularly in the last two years. Five-year numbers are preliminary and under review by PERA.



Educational Retirement Board (ERB)

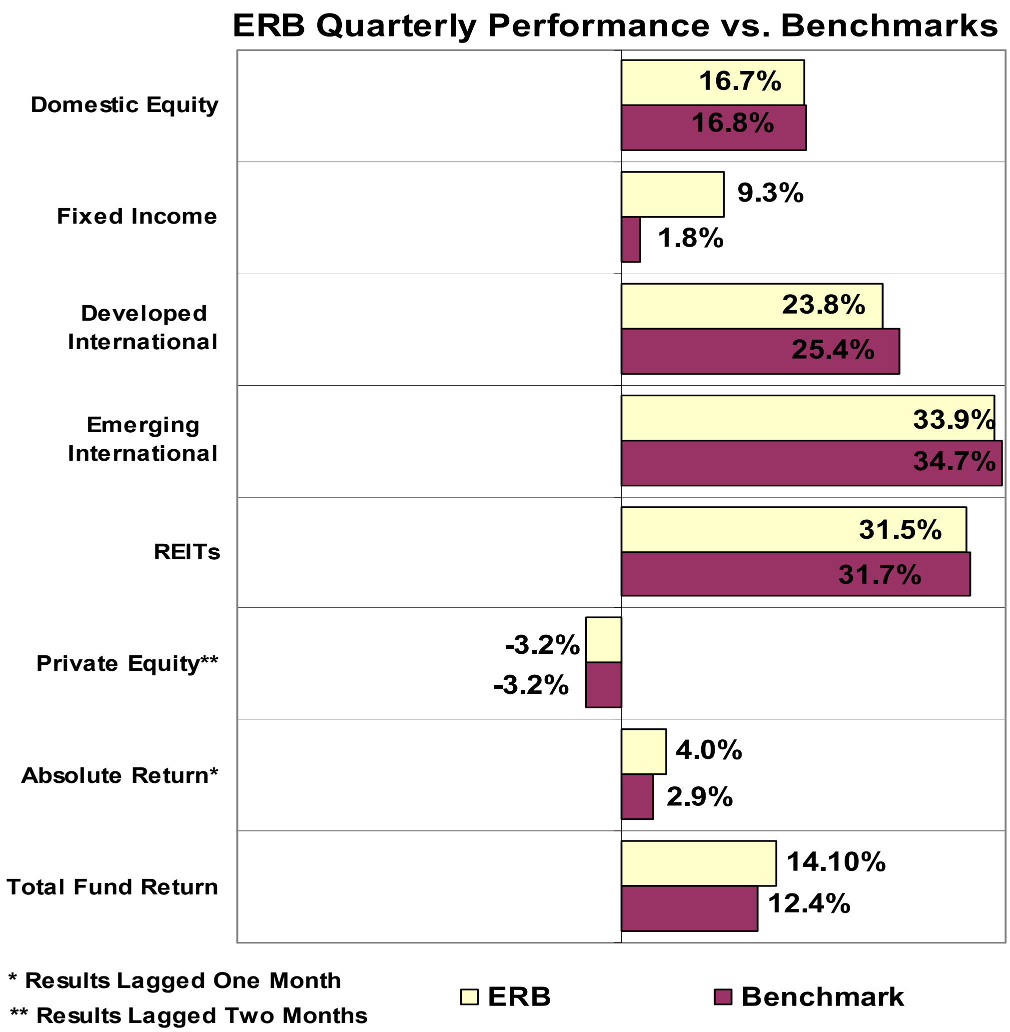
Fund Objective: ERB administers a defined benefit pension plan for public school and higher education employees. The fund is invested according to the "prudent investor rule" to ensure retirement benefits.



Fund Performance vs. Policy Benchmarks*

1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
-17.30%	-15.40%	57	2.40%	2.70%	46	2.10%	2.60%	92

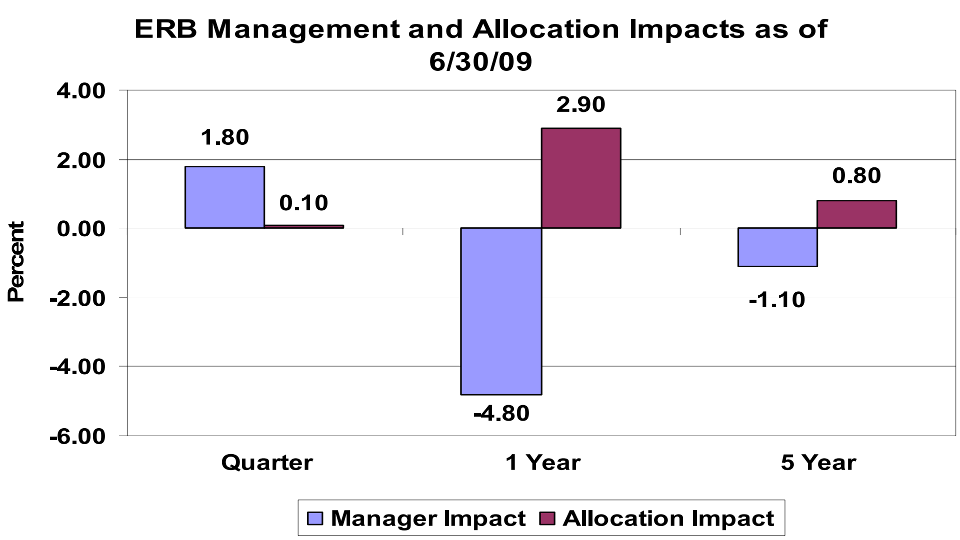
*ERB also has an 8% actuarial benchmark for funding purposes.



Overview: ERB outperformed its quarterly policy benchmark by 190 bps but continues to underperform both its one-year and five-year benchmarks by significant margins. The fund's ranking versus other U.S. public funds improved considerably in the fourth quarter to the 15th percentile; however, the fund's ten-year returns remain in the 92nd percentile. Like PERA, the fund's decline in its 10-year return to 2.1 percent is a serious concern given that the fund's investments must return 8 percent over the long term to generate sufficient funds to pay benefits. The fund's negative performance over the last two years continues to heighten concerns regarding long-term solvency.

The fund's relative performance in a number of asset classes continues to improve from the first six months of the fiscal year. Fixed income, for example, which was primary factor in the fund's underperformance early in FY09, outperformed the Barclays Aggregate Index by 750 bps and ranked in the 4th percentile of U.S. public fund fixed income returns. Believing them oversold, ERB added a strategic allocation of stressed investment-grade fixed income assets that returned 16.7 percent for the quarter. In addition, the high yield manager returned 23.1 percent, an equity-like return without the equity-like risk. Core manager returns ranged from 4.4 percent to 8.7 percent. Active management for most other asset classes also did well against benchmarks except for the international equity managers. The absolute return (hedge funds) composite, which had been the fund's worst performing asset class relative to benchmarks in the last quarter, beat its benchmark this quarter by 110 bps. However, risk as measured by five-year standard deviation has increased to 13.2, which lies substantially above the policy index standard deviation of 11.8. One asset class, Real Estate Investment Trusts (REITs), is particularly volatile, and ERB plans on reducing its exposure as return thresholds are met. These funds will be used to increase holdings in direct real estate investments.

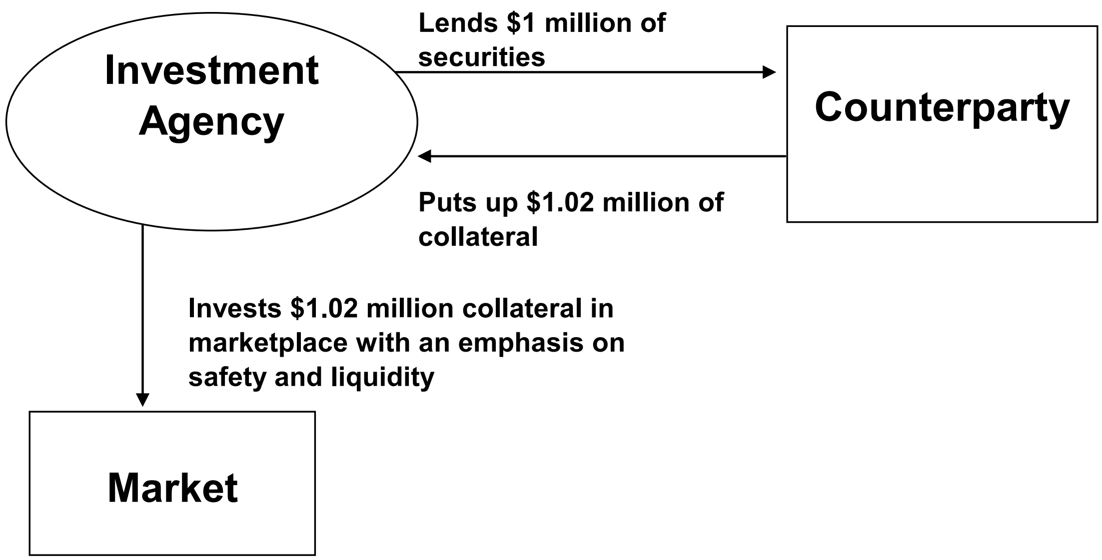
Management and Allocation Impacts: Both the fund's asset allocation and active management added value to the fund during the fourth quarter, reversing the trend of poor manager performance. ERB also attributes rebalancing its portfolio during this period (bringing equities closer to policy targets), which took advantage of the improved markets, as a contributor to fourth quarter performance. Not shown in this chart, this policy impact added another 130 bps.



SPECIAL FOCUS: Securities Lending

For some time now all three major state investment agencies have utilized an investment strategy known as securities lending. Securities lending allows a fund to lend out securities to other investors in exchange for cash collateral in an amount in excess of the market value of the loaned security. The amount of collateral required is usually determined by the creditworthiness of the borrower. This collateral can then be invested by the investment entity that lent the security, in this case the SIC, ERB, or PERA, in order to gain an additional return. Figure 1 below provides a simplified example of this process. Securities lending programs are typically managed by an external third-party for a set percentage of the program's profits. The SIC for example, operates its program through Credit Suisse for a set fee of 12 percent of any profit. Because the loaned securities are collateralized beyond 100 percent, very often this was considered to be a "riskless" transaction. Over the past 18 months much of the investment world has learned that this is untrue.

Figure 1:



Because the cash being invested through this program is collateral, most investment entities adopt strict guidelines as to how this money can be invested in order to ensure its safety and liquidity. SIC, PERA, and ERB are no exceptions to this rule and have adopted guidelines which require cash collateral to only be invested in:

- Repurchase agreements secured by at least 102 percent of the market value of the contract.
- Commercial paper issued by U.S. corporations with a "prime" rating
- Prime bankers' acceptances
- Funding agreements rated at least AA (variable rate domestic insurance company general obligations)
- Time deposits with domestic banks

The guidelines for SIC also note that "staff will focus on quality when investing cash positions…that should emphasize minimal risk." Until last fall these guidelines seemed an acceptable way of ensuring invested collateral was safe. However, on September 15^{th}

of the past year one of the nation's oldest brokerage houses, Lehman Brother's, was allowed to fail by the federal government and shock waves were sent across financial markets. Even the world's oldest money market fund, the Reserve Primary Fund, was forced to close its doors as a result. The reason for such widespread market turmoil was the fact that at the time of its failure, Lehman Brother's commercial paper held a "prime" rating from national ratings agencies. Therefore a multitude of investors around the world held that paper as an acceptable cash investment that would ensure the safety and liquidity of collateral. At the end of the fourth quarter SIC wrote down approximately $320 million in unrealized losses related to its securities lending program. ERB and PERA report unrealized securities lending losses of approximately $13 million and $100 million respectively. However, both pension funds expect some recovery from those levels and as a result have not recorded any official write downs as of yet.

Although an unrealized loss in securities lending was not uncommon for this time period, the size of the SIC loss was. CalPERS for example, the largest pension fund in the country, suffered an $845 million loss during the same time period that was roughly analogous to that of SIC. While the CalPERS loss was greater in absolute dollar amount, its overall fund asset value is just over $188 billion. The LGPF and STPF on the other hand combine for just over $11 billion in total asset value. Therefore the two losses, roughly 0.5 percent and 2.9 percent of the overall fund values, are dramatically disproportionate.

After the amount of net write downs were originally disclosed at the July SIC meeting, LFC staff inquired further as to the details of the unrealized losses. SIC staff refused to <u>publicly</u> disclose those details to both its board and relevant legislative oversight committees citing confidentiality issues related to litigation. After further requests were made, SIC staff has since publicly disclosed at its August 25th meeting which assets were involved in the write downs. A large portion, approximately $130 million, of the losses stemmed from investments in Lehman Brother's securities. The majority of the remaining losses were related to Countrywide Financial Corporation, against whom the SIC has already filed suit. Although the CUSIP numbers and cost figures were provided for all of the securities in question, SIC would not publicly provide current market values or loss estimates for the program gross of potential litigation. SIC staff discussed various aspects of this issue at the August Investment Oversight Committee meeting however they continue to cite confidentiality issues related to past litigation in their refusals to publicly disclose various pieces of information.